Weekly Intelligence Report

Our views on this week's investment events - FOR PROFESSIONAL INVESTORS - 3 May 2016

Overview

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Central bank watching is often characterised as a modern form of post-communist era Kremlinology, conjuring up images of an arcane science perpetrated by dry, stuffy academics. In the first of our articles, Tim Johnson departs from this tradition by invoking Shakespearian wordplay to explain the **Bank of Japan's surprising failure to announce any new monetary policy initiatives** last week, which confounded investor expectations and triggered a sharp yen rally and Nikkei sell-off.

In the second of our pieces, Chi Lo debunks many popular misconceptions about China and explains **how policy makers are seeking to strike a delicate balance between structural reform, economic rebalancing and policy easing.** He argues that, by and large, the authorities are succeeding in their aims of managing these three dimensions (should we call this the "Possible Trinity"?) against a backdrop of slowing secular growth.

Lastly, Richard Barwell considers **recent discussions about altering the treatment of sovereign risk for banks**. Although some commentators have argued that the implications may be so significant that the measures may never be approved, he cautions against complacency, warning that some form of reform is very likely, and that contemplated changes may have significant implications for some (particularly weaker-rated) European banks and sovereigns.

Happy reading!

"Much Ado About Nothing"

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In Shakespeare's time, the "Nothing" in his *Much Ado About Nothing* play title would have been pronounced "Noting," which referred to the characters actions of observing, listening, and writing or noting. This week, market participants were heavily engaged in this "noting" behaviour in an attempt to determine the next moves from the Federal Reserve (Fed), the Bank of Japan (BoJ), and the Reserve Bank of New Zealand (RBNZ). By the end of the week, market participants were mildly disappointed when all three central banks actually did nothing. As a result, global yields and credit spreads remained in relatively tight ranges while global equities weakened modestly due in part to the lack of further global central bank easing.

Arguably, the most important central bank inaction of the week came from the Bank of Japan (BoJ). Following deteriorating growth including -0.3% quarter-on-quarter GDP growth and a -0.1% National CPI release earlier in the week, market participants expected additional easing measures ranging from increased exchange-traded fund purchases and Japanese government bond purchases to a more negative deposit rate or an expanded loan support program at negative rates. We expected that they would embrace a domestic credit easing strategy along the lines of the European Central Bank's (ECB) recent actions and refrain from focusing on lower risk free real rates to avoid currency weakness. An increase in equity, corporate bond and Real Estate Investment Trust (REIT) purchases along with a more aggressive lending facility would have eased domestic financial conditions and likely had little impact on the yen. While we believe some yen weakness would help boost inflation, central banks have generally shied away from competitive devaluations since the apparent G20 detente agreement in mid-February. Moreover, if the BoJ acts to weaken the yen, Japan risks losing US Congressional ratification of the Trans-Pacific Partnership trade deal, a key lever for Prime Minister Abe's third arrow structural reform.

The BoJ was in a difficult situation; however the decision to do nothing may prove to be a policy error with serious consequences, particularly if perceptions that the BoJ and perhaps central banks more broadly, have lost either the will or means to act. The theme of diminished central bank effectiveness played an important role in the first quarter volatility spike and a re-emergence of this theme would destabilize financial assets and economic activity. We believe that continued yen strength or further declines in inflation expectations will reinforce these perceptions. In the near term, Japan must rely on fiscal policy in the form of supplementary budgets and wide speculation regarding a delay of the upcoming consumption tax increase. However, fiscal multipliers are typically low and raising debt to GDP from 250% to 260% is unlikely to spur growth in our opinion. Moreover, a move away from Ministry of Finance's medium term fiscal framework could exacerbate debt dynamic concerns and possibly put upward pressure on the currency.

The Federal Open Market Committee (FOMC) indicated less concern about financial market volatility and weakness in global growth in this week's statement, leaving open the possibility of a rate hike in June. Despite a considerable easing of financial conditions since the March meeting and marginal improvement in high frequency data, we expected the Committee to retain the sentence noting that "global economic and financial developments continue to pose risks", given the structural challenges in many emerging markets, Europe and Japan. While they removed it, they expanded the sentence on monitoring inflation to read, "The Committee continues to closely monitor inflation indicators and global economic and financial developments." In our view, the change is subtle and reflects a modest upgrade in their assessment, reflecting reduced market volatility and the impact of easier ECB policy while recognizing that global growth remains fragile and financial conditions could again tighten.

As expected, they did mark down their characterization of economic activity. The preliminary first quarter U.S. GDP data released this week provided more detail on the recent economic weakness. GDP growth fell from 1.4% in fourth quarter to 0.5% in Q1. Non-residential private fixed investment contracted by 5.9% (quarter-over-quarter seasonally adjusted annual rate) with much of weakness concentrated in non-residential structures and equipment. While the contraction in structures was largely energy related the contraction in equipment investment continues to be broad-based. Moreover, despite ongoing labour market strength, personal consumption expenditure growth has now decelerated for three straight quarters.

The plot of *Much Ado About Nothing* is based upon deliberate deceptions, some malevolent and others benign. While we do not believe any central bank would deliberately deceive the markets, it is inevitable that their actions will either be interpreted as constructive, benign, and at times harmful. One need only observe the currency strength in Japan and New Zealand as well as the decline in global equities to conclude this week's collective inaction was not constructive. It is too soon to tell but given the structural impediments to growth and inflation, we anticipate more easing from the RBNZ and the BOJ this year and a rate increase from the FOMC in September or December.

Is China losing control of its economy and currency?

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Worries about an economic hard-landing in China forcing Beijing to massively devalue the renminbi have sent shockwaves through global financial markets. Some investors even wonder if Beijing is losing control of its economy and currency.

If we focus on the traditional macroeconomic indicators, such as growth in industrial output, electricity consumption, freight volume and steel and cement output, they do paint a hard-landing scenario for China by showing either anemic growth rates or outright contraction. However, they only represent China's old industrial- and manufacturing- based economy. The new economy, which is represented by the service-based tertiary sector, has grown larger than the old economy, which is represented by the secondary sector, since 2013. This suggests creative destruction is underway. The traditional macroeconomic indicators have failed to capture the structural changes. The fact that China is going through a difficult transition from the old to the new economy with some setbacks in financial reforms does not necessarily spell an economic crisis.

The dichotomy in China's economy is also apparent in electricity consumption and railway transport. While electricity consumption by the old economy has been contracting, usage by the new economy has been growing steadily. Meanwhile, passenger traffic (which is related to the new economy of personal travel and domestic tourism) has been growing briskly but freight traffic (which is related to the old economy of transportation of industrial goods and materials, etc.) has been falling. The trouble at this stage is that the new economy is neither large enough nor strong enough to offset the contraction of the old economy. This argues for a policy-easing bias until economic momentum stabilises.

Further, China's progress on economic restructuring has been met by setbacks in its financial reform, notably the bursting of asset bubbles and a clumsy renminbi policy shift. All this has led to an exodus of capital recently. However, setbacks do not mean crises. Beijing is walking a fine balance between sustaining GDP growth and implementing structural reforms. The resultant creative destruction is dragging on growth and creating volatility. This situation should not be seen as a sign of Beijng losing control of the economy.

What about the currency? Some market players have used the Impossible Trinity theorem to argue that with capital fleeing China, it would not be able to keep a stable renminbi and ease monetary policy at the same time. If Beijing wants to cut interest rates to stabilise domestic GDP growth, it would have to allow a sharp devaluation in the currency, the pessimists argue.

However, the application of the Impossible Trinity analysis to China is flawed. In reality, there are no signs of capital flight. Otherwise, one should have seen a significant depletion in domestic deposits, which has not been the case. More crucially, the Impossible Trinity is not as pressing a constraint on China as many have claimed. Despite the seemingly big strides that China has taken in recent years, its capital account is still relatively closed. Most of the liberalisation measures have been aimed at institutional and official institutions' investments. Beijing has only been opening up the capital account in an asymmetric fashion by allowing capital inflows but still restricting capital outflows.

Sure, China lost about USD700 billion in currency reserves last year, despite a surplus in its basic surplus (current account balance + net foreign direct investment inflows). But a big chunk of the decline came from the valuation effect, Chinese companies repaying their foreign debt and a one-time transfer to recapitalise the policy banks.

There is no denial that there are capital outflows from China, but they do not signify Beijng losing control of the renminbi. Since there is still no full capital account convertibility, China's monetary policy will only be partly compromised if the People's Bank of China wants to keep the control of the renminbi in the medium-term.

Breaking the diabolical loop: regulating banks' holdings of sovereign debt

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One of the defining features of the crisis that engulfed the Eurozone at the beginning of this decade was the emergence of what became known as a 'diabolical loop'. The fate of Europe's banks and sovereigns had become increasingly intertwined, creating fertile breeding ground for feedback effects to emerge where bad news about one spelt bad news for the other. This vicious cycle contributed to the amplification of stress during the acute phase of the European debt crisis and breaking this diabolical loop has therefore been a key objective of policymakers ever since. This article is about one of the key outstanding reforms that is required to sever that loop, and the progress towards implementing it.

There were lots of factors which contributed to the co-dependent relationship between European banks and their sovereigns. Investors believed that sovereigns stood behind their banks, so the credit worthiness of a bank was in part a function of the capacity of its sovereign to bail it out, and the expected likelihood and cost of future bank bail-outs weighed on the health of the public finances. Moreover, the banks and the sovereign both influence and are influenced by the state of the economic cycle, such that if either one attempts to repair its balance sheet – if banks lend less or governments save more – they will tend to depress economy activity, which will then impact on the balance sheet of the other. Our focus here is on an additional source of interdependence between the banks and the sovereign which played a prominent role in the crisis: the domestic banking system's holdings of bonds issued by its sovereign.

From one perspective, the willingness of the domestic banks to invest in the debt issued by their sovereign can be seen as a positive. The banks can act as a buyer of last resort, helping to stabilise the market when transitory shocks lead to a buyer's strike among overseas investors. One could also argue that 'incentives' which 'encourage' domestic financial institutions to hold the debt of their sovereign are one way to manage a public debt problem (this argument is usually referred to as 'financial repression'). However, a system in which the banks are heavily exposed to their sovereign has a knife-edge property where if the shock is big enough then the implied losses on sovereign exposures can threaten the solvency of the banking sector, kick-starting the feedback loop discussed above. The banks come under pressure to take privately rational but potentially socially destructive defensive actions – fire-selling assets that are held by their peers, including perhaps some of their war-chest of sovereign bonds, and turning off the taps on new lending – and that drags the economy down.

By any reasonable yardstick, these portfolios of sovereign debt are large. In parts of the periphery sovereign holdings can account for 10% of the assets of the domestic banking system. If those investments were driven by fundamentals and funded in a prudent manner then these portfolios might not be such a concern. Unfortunately, that does not appear to be the case. There is a flaw in the regulatory regime under which the banks operate which favours holdings of sovereign debt relative to other assets which has contributed to the current position. At the current juncture banks may be able to fund their entire portfolio of sovereign bonds through debt (or put another way, the risk weight attached to these assets may be zero) and the usual large exposure limits which prevent banks from having too much exposure to any one credit do not apply. Banks can hold very large portfolios of sovereign debt with no capital on the other side of the balance sheet to absorb any losses. Indeed, it is possible to find banks in the periphery with exposures to their sovereign in excess of 200% of tier one capital.

This issue has been known about and discussed by the regulatory community for years. The answer seems clear: introduce sensible risk weights for sovereign bonds (that is, require banks to fund part of their portfolios through capital) and impose large exposure limits which would prevent the size of these portfolios getting out of hand. There are just two small snags. First, for certain banks in the periphery the adjustment could be painful. Just removing the zero risk weight exemption could reduce capital ratios in some quarters by over a percentage point – and typically where there is little buffer to absorb the hit. Second, and less immediately, there may be a concern about benching the buyer of last resort whilst the stock of public debt is still high, and governments will have to continue issuing large amounts of paper for the foreseeable future.

The consequences for pockets of the European banking system and to a lesser extent the sovereign bond market are thought by many investors to be so dire that policymakers will not be able to make any progress in this area. Comments by policymakers that appear to corroborate those concerns - such as those by the Governor of the Bank of Italy, Ignazio Visco, on Monday - only serve to cement market expectations that no progress can be made on this front:

'The imposition of risk weights or, worse, tight concentration limits could be particularly disruptive for banks' ability to act as shock absorbers in the event of sovereign stress. I doubt that further changes in prudential regulation are the right instrument for addressing the sovereign bank nexus. My personal view is that the potential benefits of a reform are uncertain, while the potential costs could be sizeable.'

We would caution jumping to the conclusion that the reforms will not be implemented. We know that this topic is on the agenda for Europe's finance ministers. Whilst some politicians argue that reform would be particularly onerous for high-debt countries, others appear to consider progress on this front a necessary condition if they are to give ground on a European deposit insurance scheme. Moreover, it appears that the key decision-takers within the central bank and supervisory community are basically sold on making this change. The Chair of the Supervisory Board at the ECB, Danièle Nouy, is emphatic on this point:

'I think it is very simple. We learned through the crisis that there is no such thing as zero credit risk for assets - so we have to address this issue regarding sovereigns. We have to have capital requirements based on risk weights for sovereign exposures …. For me, it is not only an issue of capital requirements for the sovereigns, because most of the sovereigns are good quality assets. (…) There is a European rule regarding large exposures, which says that no single borrower can represent more than 25% of a bank's net own funds. So let us apply this rule to sovereign bonds too.'

The official view appears to be that the change to a prudent treatment of sovereign risk needs to happen but it ought to be phased in gradually and that the change should be made at the global level rather than via a unilateral change by the European authorities. However, once it is clear that a transition will be made there is always the risk that the market will identify who stands to lose the most from the change and those institutions will come under immediate pressure. In effect, the market could compress the official transition process.

The only silver lining is the fact that the ECB is currently engaged in purchasing large quantities of government debt. At the very least, European banks can exit their positions at historically low yields. Banks would be well advised to take advantage of the window of opportunity that ECB quantitative easing affords. If they wait too long and that window has closed before they all start selling the same bonds to meet a demanding large exposure limit then the impact on market conditions – and ultimately their capital position – could be material.

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